Quarterly Newsletter
Winter 2012/2013

Lacomp plc is an independent investment management company providing portfolio management services to private investors worldwide.

2012 was a glorious year, with Union Jacks and bunting everywhere as the nation celebrated the Queen's 60 years on the throne, followed by the hugely successful London Olympics and Paralympics. There were so many feel-good factors at home that it was almost difficult to remember that elsewhere in the world, conflicts brought about human suffering on a large scale. The continuing civil war in Syria is truly atrocious, and the United Nations reckon the death toll has reached more than 60,000. Elsewhere in the Middle East, the situation in Gaza provided many flashpoints before a ceasefire agreement was reached in November. In Greece, the social unrest has become so bad that demonstrators gave up peaceful protests and resorted to attacking riot police with firebombs, and even Belfast has seen a return to sectarian violence.

Looking at financial markets, 2012 has proven to be remarkably benign. Most stock markets have registered positive returns, which is almost bizarre considering the many worrying economic realities that still persist.

Let's face it, the US only just avoided coming to grief on the so-called "fiscal cliff". This term was coined by the media to describe the problem of increasing taxes whilst achieving spending cuts, a toxic mixture for any country's economy. The idea, put very simply, was to reverse the Bush era tax cuts (dating from 2001 to 2003), increase a whole range of other taxes and bring about deep, automatic cuts in many government spending programs.

This proposed action was seen as too much too quickly, and the fear was that the American economy would immediately go back into recession. Breaking up the deal into two or three parts was judged to be the solution to this conundrum. Therefore, the term "cliff" turns out to be something of a misnomer, because we now have three separate parts of it, so it really should be renamed "fiscal cliffs".

The first "cliff" dealt with taxation, but the issues were partly fudged, delayed or tempered. The next "cliff" (referred to as "sequester legislation") is imminent, in about a month's time, and will deal with the planned automatic, across-the-board government spending cuts. The debate will revolve around the questions of where and how big the cuts should be, and in case the American politicians cannot reach an agreement, the automatic across-the-board cuts would become the default position.

Following that, we shall have a repeat of the unedifying spectacle of political head butting we witnessed back in 2011 over the question of raising the debt ceiling. The same issue will have to be addressed again this year. You will recall that it caused major upheavals two years ago, and the problem this time is very similar: either the politicians agree to raise the debt ceiling, or parts of the US government machine would have to shut down. The only alternative for the Americans is to default on their sovereign debt!

One thing is for certain: the infighting between the Democrats and the Republicans will be ugly, and although they usually manage to reach an agreement at the very last moment, the process of getting to an agreement inevitably will cause uncertainty in the markets, which is precisely the one thing we could do without.

Talking of potential uncertainty, we need look no further than Westminster where Prime Minister David Cameron earlier on today delivered what can only be described as a watershed speech. The Tory leader has been under considerable pressure from his backbenchers for a number of reasons. Staunch Conservatives have frequently questioned his adherence to the party's time-honoured philosophy and many have been unhappy about certain aspects of the coalition, but it has been the Eurosceptics that increasingly have been rattling his cage. In addition, there was the perceived threat that UKIP might persuade traditional Tory voters to abandon their party as well as a rather flaky Labour line over Europe – let us not forget that there are deep divisions on the subject in both major parties. Whatever his motivation, David Cameron has now come out of his corner and firmly put the question of continued EU membership centre stage.

In his speech, he stated that he wanted to renegotiate the terms of the UK's EU membership, and only after that had run its course, would he ask the electorate for their opinion by holding an "in-out" referendum, likely to be in 2018. He also hinted that the eurozone, i.e. the countries that have adopted the euro as their currency, would have to first deal with its own problems, which might be seen as a euphemism for not wanting to say that he expects the eurozone as we now know it to unravel or disintegrate by that time. Of course, he will only be able to see through this plan of his provided the Tories win the next General Election, so his offer of a referendum, a topic which has dogged a succession of Prime Ministers, could be seen as a bit of early electioneering. In truth, there are many "ifs" and "buts".

Initial reactions from across the Channel were interesting: both the French and German Foreign Ministers criticised Mr. Cameron, saying respectively "you can't do Europe à la carte" and "cherry picking is not an option". However, it will be far more interesting to learn what Mrs. Merkel, the real power broker in the EU, will make of the speech, and it would not be surprising if she adopted a more pragmatic stance.

Of course, there has always been an anti-Britain faction in Europe, dating back to Charles de Gaulle who twice vetoed UK's membership of the then EEC in the sixties. Later on, Mrs. Thatcher ruffled a few feathers in 1984 when she demanded, and got, a significant rebate on the UK's contribution to the EU budget. The relationship between the EU and Britain has never been a cosy one, and whilst some EU politicians gladly would see the back of Britain as a member, the majority would like to retain the status quo and keep Britain within the EU. Clearly, David Cameron's speech will be viewed as a shot across the bow inasmuch as he wants to ensure being taken seriously when it comes to renegotiating the terms of our membership.

It seems to be a day for important announcements. The Japanese central bank today reported that whilst it would continue with and extend its quantitative easing program, it would wait until next year to start its open-ended purchase of assets in order to replace deflation with an inflation target of 2%. This marks a departure for the Bank of Japan which has kept its benchmark interest rate at near zero percent for most of the last twenty years. Although the central bank is meant to be independent, it has come under a lot of pressure from Prime Minister Abe, who was returned to his former status following the landslide victory of his Liberal Democratic Party last September. Abe is desperate to kick-start the sluggish Japanese economy, but his current plan is not that different to what has been tried before, albeit without much success. The immediate reaction by investors is ominous: the Bank of Japan's declaration failed to boost markets today. Indeed, the Nikkei 225 index recorded a negative 2%!

Luckily for Prime Minister Abe and his party, Japan - unlike Italy or Greece - does not have to go abroad with cap in hand looking to raise money to fund and service its ever-increasing debt mountain. Most of the debt, which now amounts to some 240% of GDP (i.e. roughly twice the size of the Italian debt and about 50% higher than the Greek debt!) is held by its own citizens.

What Japan really needs is not more of the same but proper reform. There still is far too much bureaucratic red tape, and unreasonable trade barriers remain in place. Above all, the Japanese continue to display an almost inherent resistance to change.

Against this background of uncertainty, what can we really expect from 2013? After all, we are still faced with more or less the same problems the powers that be tried to solve a year ago. The eurozone crisis presents as much of a headache as it did then, and a calamity was only avoided in July when Mario Draghi, the ECB president, pledged to do "whatever it takes" to protect the eurozone from collapse. Amazingly, that statement alone gave investors confidence and European markets rallied, with the euro also beginning a stunning recovery. It almost defies belief that Signor Draghi's statement, in the face of adversity, could have such a positive effect.

The money printing presses have been kept rolling, seemingly totally ignoring the potential sting in the tail in the form of higher inflation, and borrowing is still on the up in America, as it is in Britain where it has just been announced that monthly borrowing figurers have increased month by month since July. Although UK employment figures have been pleasing, the economy is still largely inert and there is every chance that we are heading for a triple dip recession.

It could be that what was considered as potentially very dangerous a while ago is now being accepted as a form of new reality that we must and can live with. Maybe investor sentiment is such that this long bull market, unspectacular though it has been, is not just yet hitting the buffers. Be that as it may, we at Lacomp remain sceptical and stick to our defensive stance.

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